

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 94-0891 RST**

**Sales/Use Tax — Equipment Used in Remanufacturing Operations
Sales/Use Tax — Shipping Containers
Sales/Use Tax — Utilities: Electricity and Natural Gas
Tax Administration — Penalty**

For Tax Periods: 1991 Through 1993

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ISSUES

I. Sales/Use Tax — Equipment Used in Remanufacturing Operations

Authority: IC 6-2.5-5-3(b); IC 6-2.5-5-5.1(b)
Rotation Products v. Department of State Revenue, 690 N.E.2d 795,800 (Ind.Tax 1998)
Mid-America Energy Resources, 681 N.E.2d at 262 (Ind. Tax 1997)

Taxpayer objects to the assessment of Indiana use tax on purchases that were classified by Audit as "Purchases Used in Service Operations."

II. Sales/Use Tax — Shipping Containers

Authority: IC 6-2.5-5-9(d)
45 IAC 2.2-5-16(a)

Taxpayer protests the proposed assessment of Indiana use tax on its purchase of nonreturnable shipping containers.

III. Sales/Use Tax — Utilities: Electricity and Natural Gas

Authority: 45 IAC 2.2-4-13; 45 IAC 2.2-5-12

Taxpayer protests the proposed assessment of Indiana use tax on its purchase of electricity and natural gas.

IV. Tax Administration—Penalty

Authority: IC 6-8-10-2.1
45 IAC 15-11-2; 45 IAC 2.2-3-20

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana corporation, has two main operating departments. The activities conducted in one department are not at issue. In the AP Department, taxpayer performs two primary activities - taxpayer manufactures a type of ring, and taxpayer remanufactures the same type of ring. The rings subsequently remanufactured are supplied by either taxpayer or taxpayer's customers.

Both taxpayer and audit agree that taxpayer's production of new rings is a manufacturing activity. However, they disagree as to the characterization of remanufacturing activities. Taxpayer considers "remanufacturing" to be a subset of the manufacturing process. Audit, however, characterizes "remanufacturing" as a function of repair – a service activity.

I. Sales/Use Tax — Equipment Used in Remanufacturing Operations

DISCUSSION

Companies are taxpayer's primary customers. Some purchase new rings from taxpayer; others purchase remanufactured rings. A majority, however, send its used (worn or damaged) rings to taxpayer for remanufacturing.

Taxpayer's remanufacturing process consists of several steps - cleaning, machining, application of a new liner, heat sealing, and then re-machining. All of these steps are necessary because remanufactured rings must meet the same specifications as that of new rings.

Audit has characterized "remanufacturing" process as a repair activity. Audit reasons that since the tangible personal property being repaired (the ring) was incidental to the labor involved, the activity is properly characterized as one of service. Consequently, Audit denied taxpayer use of any of the industrial exemptions.

Taxpayer responds by arguing that the remanufacture of rings is a manufacturing activity. Taxpayer refutes Audit's conclusion to the contrary by noting that service activities are usually performed on property owned by another. Taxpayer comments that title to some of the used rings - rings subsequently remanufactured - remain with taxpayer throughout the remanufacturing process.

In Indiana, an excise tax (sales tax) is imposed on retail transactions. A complementary excise tax (use tax) is imposed on tangible personal property that is stored, used, or consumed in this state. Several exemptions from these taxes are available. Taxpayer invokes two of the industrial exemptions.

Referred to as the equipment exemption, IC 6-2.5-5-3(b) reads:

Transactions involving manufacturing machinery, tools and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, processing, refining, or finishing of other tangible personal property.

The relevant part of IC 6-2.5-5-5.1(b), the consumption exemption, reads:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

From a reading of the industrial exemption statutes, it is clear that these exemptions are not limited to only those taxpayers engaged in manufacturing activities. While taxpayer argues forcefully for the application of the manufacturing label to its activities, such effort is unnecessary. The relevant issue is whether taxpayer's activities actually constitute production. See *Rotation Products v. Department of State Revenue*, 690 N.E.2d 795,800 (Ind.Tax 1998). In

other words, does taxpayer's operations create a marketable good? See *Mid-America Energy Resources*, 681 N.E.2d at 262 (Ind. Tax 1997).

In *Rotation Products*, the Indiana Tax Court addressed whether the remanufacture of roller bearings constituted production of tangible personal property within the meaning of the industrial exemptions - even assuming the remanufacturing activities in question were properly characterized as repair activities. In reaching its conclusion, the court in *Rotation Products* engaged in a four-factor analysis. The questions the court considered relevant were:

- (1) does the work performed result in a substantially different end product as measured by the substantiality and complexity of the work done on the existing article and the physical changes to the existing article?
- (2) how does the article's value compare with its value after the work is completed?
- (3) how favorably does the performance of the remanufactured article compare with the performance of newly manufactured articles of its kind?
- (4) was the work performed contemplated as a normal part of the life cycle of the existing article?

After conducting its analysis, the court concluded the remanufacture of roller bearings constituted production of tangible personal property. Consequently, the Rotation Products Corporation was entitled to the industrial exemptions. *Rotation Products* at 804.

While this taxpayer does not remanufacture roller bearings, taxpayer's activities are similar to those activities conducted by the Rotation Products Corporation. Taxpayer, through its various processes, transforms worn, and possibly damaged, rings - rings with limited utility and life - into valuable and marketable commodities. Through machining, application of new ring liners, and heat treatment, taxpayer produces a remanufactured ring which meets new ring specifications.

Therefore, consistent with the language of IC 6-2.5-5-3(b) and IC 6-2.5-5-5.1(b), and the court's analysis in *Rotation Products*, the Department finds the production of remanufactured rings entitles taxpayer to the exemptions provided by the industrial exemptions.

These exemptions apply not only to the remanufacture of rings owned by taxpayer, but also to the remanufacture of rings owned by taxpayer's customers. For purposes of determining whether production has occurred, ownership of the property is not relevant. As the court in *Rotation Products* stated, "having a rule that work done on the property of another cannot constitute production improperly makes the relationship between two taxpayers the

determinative factor. Instead, the focus should be on the activity alleged to constitute production." *Id.* at 801 fn 12.

FINDING

The Department finds to the extent taxpayer purchased equipment and consumables used in the remanufacture of rings, taxpayer is entitled to the industrial exemptions. Taxpayer's protest is sustained.

II. Sales/Use Tax — Shipping Containers

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on its purchase of nonreturnable shipping containers

Taxpayer purchased shipping containers that were used in the transport of both manufactured and remanufactured jet engine rings. Audit estimated, from figures provided by taxpayer, that twenty-five percent (25%) of taxpayer's purchases were used in the transport of "repaired" - i.e., remanufactured - merchandise. Therefore, 25% of taxpayer's purchases of shipping containers and packaging supplies were assessed by Audit.

According to IC 6-2.5-5-9(d):

Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

Indiana Regulation 45 IAC 2.2-5-16(a) reinforces this statutory language:

The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

The statutory and regulatory language clearly state that eligibility for the nonreturnable container exemption is contingent upon the contents of the container. Specifically, the container must hold products that are being sold. However, taxpayer is not using its shipping containers exclusively for that purpose. When taxpayer returns the original remanufactured ring to its customers,

taxpayer is not selling the contents of the container. Rather, taxpayer, much like a bailee, is *returning* property to its legal owner.

FINDING

Taxpayer's protest is denied.

III. Sales/Use Tax — Utilities: Electricity and Natural Gas

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on purchases classified by Audit as "Utilities - Electricity & Natural Gas."

Generally, the purchase of utility services are subject to Indiana sales and use tax. As 45 IAC 2.2-4-13 (a) instructs, "the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumers is subject to [Indiana sales] tax." However, 45 IAC 2.2-4-13(c) provides an exemption for "[s]ales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction" as long as the services "are separately metered or billed and will be predominately used for the excepted purpose."

Audit reasoned that taxpayer could not take advantage of this exemption because taxpayer was not primarily engaged in business as a manufacturer; less than 50% of *taxpayer's receipts* were derived from manufacturing operations. Consequently, taxpayer's utility purchases were not "used predominantly for excepted purposes." However, to the extent that taxpayer's purchases were "directly consumed in manufacturing, processing, refining or mining" these purchases qualified for an exemption. (See 45 IAC 2.2-5-12(a)). Under this analysis, Audit calculated that 19% of taxpayer's electricity and natural gas purchases were taxable.

Audit misreads the utility exemption. Predominate use is not measured by the amount of receipts in any given area. Rather, predominate use refers to how the utilities are actually used in taxpayer's business. Regardless of the measure of taxpayer's receipts, if 51% of taxpayer's use of utilities is for exempted purposes, then the exemption afforded by 45 IAC 2.2-4-13(c) may be employed.

Additionally, the calculus has changed. The Department has previously concluded that taxpayer's remanufacturing activities constituted production. Therefore, the percentage of utility

usage Audit apportioned to remanufacturing activities should be included in taxpayer's percentage of use for "excepted purposes."

FINDING

Taxpayer's protest is sustained.

IV. Tax Administration — Penalty

DISCUSSION

The taxpayer protests the imposition of the ten-percent (10%) penalty. The negligence penalty imposed under IC 6-8.1-10-2.1(e) may be waived by the Department where reasonable cause for the deficiency has been shown by the taxpayer. Specifically:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. 45 IAC 15-11-2(e).

Since taxpayer has prevailed, or substantially prevailed, on most of the issues in this protest, application of the negligence penalty would be inappropriate.

FINDING

The taxpayer's protest is sustained.